Board of Commissioners of Public Utilities Newfoundland Power 2006 Accounting Policy Application

Grant Thornton

Contents

Introduction and Scope

Newfoundland Power Inc. ("the Company") filed an application with the Board of Commissioners of Public Utilities ("the Board") on September 29, 2005. The primary purpose of this Application is to request the Board approve a proposed change in accounting policy for revenue recognition and changes related to certain transitional issues and consequential matters arising that are related to the accounting policy change.

In the Application, Newfoundland Power is seeking an order approving:

1. Newfoundland Power's adoption of the Accrual Method of revenue recognition commencing in 2006;
2. the application of $9,579,000 of 2005 Unbilled Revenue to Newfoundland Power's 2006 revenue for regulatory purposes;
3. the application of $295,000 of 2005 Unbilled Revenue to dispose of the current balance in the Reserve in 2006;
4. that the average value of the unrecognized 2005 Unbilled Revenue be deducted from rate base commencing in 2006; and
5. a 2006 forecast for rate base of $744,326,000 and a 2006 forecast for invested capital of $745,752,000 to be used in the Formula in calculating Newfoundland Power's return on rate base.

The Board has requested that we undertake a review of the Company's Application and pre-filed evidence and issue a report based on our findings. Specifically, the scope of our review of the Application and pre-filed evidence is as follows:

- Review and comment on the Company's proposal for changing its revenue recognition policy for regulatory purposes from the "Billed Method" to the "Accrual Method" commencing in 2006 including:
    a. Review of the Revenue Recognition Study provided by the Company;
    b. Review of the calculations and support provided for the accrued revenue as of December 31, 2005; and the Company's proposal to recognize this on a prospective basis over a transitional period;

c. Review the appropriateness of the Company's proposal for recognition of the accrued revenue, including the impact of depreciation and income tax expenses in 2006, the proposed treatment of the "Unbilled Revenue Increased Reserve" in 2006 and the impact on rate base during the transitional period.

- Review the Company's 2006 forecast for rate base and invested capital to be used in the Automatic Adjustment Formula in calculating the Company's return on rate base, and the transitional proposals put forward by the Company, including:
    a. The appropriateness of the calculations and support provided by the Company;
    b. The inclusion in the 2006 rate base of the unrecognized accrued revenue;
    c. Changes in the methodology which will move the Company closer to the Asset Rate Base Model, including the use of book equity as opposed to regulated equity in the calculation of invested capital.

We have conducted our review in accordance with the scope described above and our findings and comments with regards to the Application and related proposals are contained in the sections of the report which follow.

Revenue Recognition

Accounting Policy Change for Revenue Recognition

In P.U. 36 (1998 - 1999), the Board recognized an issue with respect to the Company's revenue recognition policy and the timing of the application of rate changes. The Company recognizes revenue when it is billed to consumers and the Board ordered the application of rate changes to be based on consumption. In P.U. 36 (1998-99), the Board ordered the Company to commission a study on the appropriate basis of recognizing revenue, commonly referred to as "the Revenue Recognition Study". It was ordered that the study:

> *" provide an updated survey on revenue recognition policies of Canadian gas and electric utilities, the full implications of changing the revenue recognition policy on both financial reporting and revenue requirement, the accounting treatment applied by other Canadian gas and electric utilities which changed their revenue recognition policy and the recommendation of the company."*

The study was required to be filed with the Board before the next general rate application or by March 31, 2000, whichever was earlier. The Board later amended this Order by deleting the reference to March 31, 2000 and substituted it with *"at such time to be determined by the Board."*

The issue of the revenue recognition study was raised during the 2003 General Rate Hearing. The Company requested deferral of the outstanding issues relating to the revenue recognition study pending resolution of a dispute with Canada Revenue Agency (CRA). As indicated during prior hearings before the Board, and in this Application, the Company was in a longstanding dispute with the CRA concerning its historical practice of revenue recognition for tax purposes and CRA had reassessed the Company's income tax returns for 1988 through to 1999. The Company's concern with regards to filing the study during the 2003 Hearing was that it could potentially prejudice the Company's position with respect to its dispute with CRA. The Board accepted the Company's position on this matter and approved deferral of the outstanding issues pending resolution of the dispute with CRA. The Board indicated in P.U. 19 (2003), page 87, that it would "deal with any issues arising from the final decision of the tax case, including any potential liabilities or benefits to ratepayers once the case has been resolved."

In an agreement dated June 2005, the Company and CRA settled the dispute concerning its practice of revenue recognition for income tax purposes. Under the terms of the Tax Settlement the Company agreed that it would recognize revenue using the Accrual Method for income tax purposes commencing in 2006.

Accordingly, the Company has filed its revenue recognition study and applied to change its policy from recognizing revenue using the "Billed Method" to the "Accrual Method" for regulatory purposes.

The Tax Settlement

As indicated in the Company's Application, there was over $16 million in income tax and interest at issue with regards to the case disputing the Company's historical practice of revenue recognition for income tax purposes. According to the Tax Settlement filed with the Company's Application (NP-1), CRA has agreed to cancel the Revised Reassessments that were previously issued; and refund with applicable interest all amounts that were held on deposit by the CRA in relation to the Revised Reassessments. In accordance with the provisions of the Income Tax Act, the Company had been required to place approximately $6.9 million on deposit with CRA while this case was ongoing. As noted, the resolution of the case has also resulted in CRA returning the deposit to the Company, including any interest earned while the deposit was held by CRA. According to PUB 10 NP, the Company received approximately $2.1 million in interest and this interest income is currently recorded as "other income" in 2005.

We have reviewed the response to PUB 10 NP and agree with the Company that generally accepted accounting principles (GAAP) require that this revenue be recognized as income in 2005.

The Board may want to consider whether the interest income arising from the Tax Settlement should be incorporated with the transitional issues noted in this Application. If so, the Board would need to make a decision on this issue before the Company is required to finalize its December 31, 2005 financial statements, otherwise the Company will have to record the interest income in 2005 to be in accordance with GAAP.

"Billed Method" versus "Accrual Method"

The differences between the two revenue recognition policies are explained in detail in the Company's Application. The "Billed Method" recognizes revenue as it is billed to the customers. Accordingly, total revenue in any given fiscal year consists of billings for usage from approximately ½ month of the past calendar year plus approximately 11 ½ months of the current calendar year. The "Accrual Method" recognizes revenue as the electricity is consumed by the customer, regardless of whether the customer has been billed at that time, therefore total revenue for the year is comprised of the twelve months of the current year. It is important to note that the cash flow available to the Company at any given time remains the same under both methods; the bill is still sent to customers on the same date, the difference is when the revenue is reported on the Company's financial statements.

Adoption of the Accrual Method of recognizing revenue will also result in an accounting policy that is consistent with the method used by the Company to recognize and record expenses that are incurred to deliver electricity to consumers. The Company currently records the majority of its expenses such as purchased power from Hydro, labour, etc. that were incurred as at December 31st. The expenses that are not billed to the Company by that date are accrued. The accrual of expenses incurred to earn income is in accordance with generally accepted accounting principles. Currently, the Company is using the Billed Method to recognize revenue and the Accrual Method to recognize expenses incurred, therefore the approval of the Accrual Method to recognize revenue would provide for better matching between the Company's revenue and expenses.

Revenue Recognition Study

The Company has included the Revenue Recognition Study ("the Study") in its Application (Exhibit NP-3). In compliance with applicable Board Orders this Study includes the following:

- a discussion on the underlying methodology of the accrual versus the billed method of revenue recognition;
- a discussion of Canadian standards and practices with regards to financial reporting, income tax and regulatory practice, including the results of the Company's survey of other Canadian Utilities.
- the impact of adopting the accrual method for recognizing revenue, including the regulatory impact and transitional matters that would require consideration.

Financial Reporting Standards

The principles used in reporting revenue for financial reporting purposes are set out in the Canadian Institute of Chartered Accountants ("CICA") Handbook and are commonly referred to as generally accepted accounting principles ("GAAP"). The section of the Handbook that specifically deals with revenue is *Section 3400 - Revenue*, and recognition is addressed in *Section 3400.06*, which states:

> *"Revenue from sales and service transactions should be recognized when the requirements as to performance set out in paragraphs 3400.07 -.08 are satisfied, provided that at the time of performance ultimate collection is reasonably assured."*

Paragraph 3400.08, which relates to service transactions goes on to say that:

> *"….Such performance should be regarded as having been achieved when reasonable assurance exists regarding the measurement of the consideration that will be derived from rendering the service…."*

These sections of the Handbook state that revenue would normally be recognized using the accrual method. In Newfoundland Power's circumstances, GAAP would require that revenue be recognized when the customer consumes the electricity - it is at this time that reasonable assurance exists of the amount of revenue that would be derived from consumption of the electricity and ultimately collected.

However, it is worthy to note that even though the Company's current practice of revenue recognition does not appear to be in accordance with GAAP, Section 1100 of the CICA Handbook effectively permits rate regulated entities to recognize revenue under methods other than the Accrual Method, if ordered to do so by their regulatory body. Therefore the Company's use of the Billed Method is currently in compliance with GAAP.

We note that the CICA has commissioned a review of rate regulated operations and it is possible that this "exemption" in Section 1100 may be removed by the CICA.

Income Tax Reporting

In accordance with the Tax Settlement, revenue earned by Newfoundland Power is required to be recognized using the Accrual Method for income tax purposes. The Company will begin using the Accrual Method of revenue recognition for income tax purposes commencing in 2006.

As agreed in the Tax Settlement, the Company is permitted to recognize, for tax purposes, the Unbilled Revenue as of December 31, 2005, in equal amounts over a three year period beginning in 2006.

Other Canadian Utilities

As ordered by the Board in P.U. 36 (1998 - 1999), the Company was required to provide an updated survey on revenue recognition policies of Canadian gas and electric utilities, and the accounting treatment applied by the other Canadian utilities which changed their revenue recognition policy.

The Company has included in its study the survey results of twenty-seven Canadian utilities, which are detailed in Appendix A and B of the study. Of the twenty-seven surveyed, twenty-three utilities responded to the survey and all respondents are currently using the Accrual Method for recognizing revenue for regulatory purposes. Thirteen of the respondents always used the Accrual Method. Of the remaining ten respondents, two utilities indicated that the change was treated retroactively, meaning that the unbilled revenue existing at the date of transition was applied as a direct adjustment to retained earnings. Three utilities had prospectively recognized its entire unbilled revenue as revenue in the year of transition. The remaining five utilities who responded did not indicate which accounting treatment was used when the Accrual Method of revenue recognition was first adopted.

Newfoundland Power is proposing that its Unbilled Revenue as of December 31, 2005, which it has estimated to be $24,262,000 be transitioned, on a prospective basis. However, the Company is recommending that the Unbilled Revenue be recognized over a period of time. The Company's proposal for a transitional methodology will be discussed in further detail in the next section of our report.

Based on the results of the survey, Board approval of Newfoundland Power's request to adopt the Accrual Method of revenue recognition for regulatory purposes would cause the Company to follow a practice that is prevalent among Canadian Utilities.

Conclusion

Based on our review of the Company's Application, the Revenue Recognition Study, Mr. J.T. Browne's report - "Changes to Regulatory Accounting Policies", and our knowledge and experience with GAAP and the requirements of the Income Tax Act, it is evident that the Accrual Method of recognizing revenue for regulatory purposes would be consistent with current practices. To summarize:

- Section 3400 of the CICA Handbook recommends the Accrual Method of revenue recognition for financial reporting purposes;
- the Income Tax Act requires the Company to recognize its revenue using the Accrual Method for tax purposes; and
- all utilities (23) that responded to the Company's survey use the Accrual Method of revenue recognition for regulatory purposes.

For the reasons stated above we support the Company's proposal to adopt the Accrual Method. This would also assist in the consistency among the Company's reporting requirements of its results for financial, income tax and regulatory purposes. The continued use of the Billed Method for regulatory purposes would result in the Company reporting its financial results differently for income tax and for regulatory purposes. With the changes proposed for GAAP by the CICA, the reporting process as a result of these differences could become more complicated.

Calculation of 2005 Unbilled Revenue

Newfoundland Power has estimated that the amount of unbilled revenue as of December 31, 2005 will be $24,262,000, representing a balance sheet accrual as of that date. The Company has indicated in its application that "this accrual can , within limits, be used to offset Newfoundland Power's future revenue requirements and represents a potential future benefit for Newfoundland Power's customers."

The Company's calculation of this accrual is included in Exhibit NP-4 of its Application. The accrual is calculated in the following manner:

> The January, 2006 forecast billings are calculated using the customer and energy sales forecast dated March 31, 2005, excluding energy sales to Memorial University and forfeited discounts, and the rates approved by the Board effective as of January 1, 2005. The forecast billings for January, 2006 is calculated to be $44,375,000.
>
> The forecast January, 2006 billings are allocated among 19 billing cycles that occur during the month of January. The percentage of billings in each cycle is then determined as a percentage of total billings for the month.
>
> The meter reading dates for each cycle are noted. All billing cycles begin at some date in December and end at some date in January. Based on the number of days in the billing cycle, it is determined how many of the days occur before January, 2006 and how many days are after.
>
> The percentage of days before January, 2006 is determined for each billing cycle and the total of these percentages accumulate to determine the percentage of revenue that would represent revenue earned in December, 2005 but billed in January, 2006. This percentage is calculated to be 54.40%. It is important to note that in preparing this calculation the Company has made an assumption that there will be an equal amount of revenue per day per billing cycle.

The January 2006 forecast forfeited discounts of $225,000 is added to the January 2006 forecast billings of $44,375,000 and the 54.40% is multiplied by the total to determine the unbilled revenue that would exist as of December 31, 2005.

In response to PUB 13 NP, the Company states that the revenue associated with Memorial University is omitted from the calculation because the customer is billed at the end of each month. Therefore, there would be no unbilled revenue at the end of the year attributable to this customer.

We have reviewed this methodology and the Company's calculations and can conclude that the method of estimating the accrual is reasonable and no errors were noted in the calculations.

Transitional Accounting Issues

Newfoundland Power identifies a number of transitional issues associated with the adoption of the Accrual Method of revenue recognition in 2006. These transitional issues include:

1. The appropriate accounting treatment for the 2005 Unbilled Revenue;
2. Recognition of a portion of the 2005 Unbilled Revenue ($9,579,000) in the 2006 fiscal year to offset increased depreciation expense and income tax effects;
3. Disposition of the balance of the Unbilled Revenue Increase Reserve ($295,000); and
4. Impact on rate base of the balance of the 2005 Unbilled Revenue during the transition period.

For purposes of our discussion we have grouped the four issues into two categories. The first and fourth issues deal with certain consequential financial and regulatory reporting implications associated with accruing $24.3 million additional revenue at December 31, 2005. The second and third issues represent Newfoundland Power's proposals for partial disposition/recognition of the 2005 Unbilled Revenue.

In considering the identified transitional issues and related proposals from the Company and ultimately the disposition of the full balance of the 2005 Unbilled Revenue, it is important to note that with a change to the Accrual Method of revenue recognition there would be no additional cash revenue to the Company. Under both the Billed and Accrual Methods the total cash received by Newfoundland Power and the timing of cash receipts are the same. The Unbilled Revenue of $24.3 million represents an accounting accrual at December 31, 2005.

Financial and regulatory reporting implications

Financial reporting requirements

As noted by Newfoundland Power, for financial reporting purposes the 2005 Unbilled Revenue, estimated to be $24,262,000, must be reported as both an asset and a liability in its financial statements as of December 31, 2005. This treatment is necessary to comply with a recent accounting guideline (AcG-19) issued by the Canadian Institute of Chartered Accountants. The Unbilled Revenue will be reported as accounts receivable with a corresponding regulatory liability.

We have reviewed these recent reporting requirements and concur with the position taken by the Company in this regard.

Recognition for regulatory purposes

Newfoundland Power is proposing that the unbilled revenue as of December 31, 2005 be recognized on a prospective basis. Generally accepted accounting principles would normally require changes in accounting policy be applied on a retroactive basis. However, as the Company points out in its Revenue Recognition Study, such an approach would deny ratepayers any benefit from recognition of the unbilled revenue.

Newfoundland Power is also recommending that the Unbilled Revenue be recognized over a transitional period as opposed to recognizing all of it in one year. The transitional methodology is proposed as a means to balance the interests of customers with those of the Company. Under this approach, customers would receive the benefit of the 2005 Unbilled Revenue by way of offset with respect to future revenue that would otherwise be required through rates. From the Company's perspective, recognition of this non-cash revenue over a transition period minimizes the impact on its financial integrity.

We believe a prospective recognition of the 2005 Unbilled Revenue over a transition period is a reasonable approach to dealing with this issue from a regulatory perspective.

Impact on Rate Base during Transition Period

As noted above, the unrecognized portion of the 2005 Unbilled Revenue will be reported as a regulatory liability (or deferred revenue) as at December 31, 2005 and for future accounting periods until the transition period is completed. Newfoundland Power is proposing that the average value of this regulatory liability be deducted from the rate base commencing in 2006 until the end of the transition period. In support of this proposal, the Company states that conceptually there is no difference between this deferred liability account and other deferral accounts which are part of the rate base such as the Weather Normalization Reserve, deferred income taxes and deferred charges.

We concur with Newfoundland Power's position on this matter and believe that the proposal to reduce the rate base by the average value of the unrecognized 2005 Unbilled Revenue is reasonable.

Proposals for partial disposition of the 2005 Unbilled Revenue

The Company is proposing that it recognize for regulatory purposes in 2006 an amount of $9,579,000 of the 2005 Unbilled Revenue to offset certain increased costs:

- increased depreciation expense of $6,950,000; and
- income tax effects of $3,086,000 relating to recognition of the Unbilled Revenue for tax purposes in accordance with the Tax Settlement.

The Company is also proposing that a portion of the 2005 Unbilled Revenue be applied to eliminate the balance of $295,000 in the Unbilled Revenue Increase Reserve.

In its submission Newfoundland Power has effectively stated that, in the absence of offsetting revenues, the increased costs noted above will result in a return on rate base in 2006 below the current allowed range and below what it would consider as a fair and reasonable return. This is essentially the basis for its proposal. The $9.6 million proposed to be recognized represents approximately 2.3% of forecast revenue for 2006. The Company states that the proposal "…defers an otherwise necessary rate increase in 2006…".

It is important to note that the amount of revenue required to offset the forecast increased expenses is dependent on how the additional revenues are derived. The choice is between imposing higher rates or by recognizing a portion of the 2005 Unbilled Revenue. This difference arises because of the associated income tax implications. Newfoundland Power addresses this point in its evidence and provides a calculation of the impact in Exhibit NP-6. Any increased revenue achieved from higher rates would attract additional income taxes and would therefore need to be grossed up. By comparison recognizing a portion of the 2005 Unbilled Revenue would not attract any additional taxes other than tax effects of the settlement.

Increased depreciation expense

The increased depreciation expense is comprised of two components. The first relates to the conclusion of the true-up adjustment and amounts to $5.793 million. The second component represents the impact of increased plant investment and amounts to $1.157 million.

The depreciation true-up adjustment was proposed by Newfoundland Power and accepted by the Board during the 2003 GRA. This true-up was based on the Company's 2002 depreciation study which calculated a reserve variance of approximately $17.2 million. This variance was being amortized over a three year period from 2003 to 2005 in accordance with P.U. 19 (2003). The true-up adjustment, which is recorded as a reduction in depreciation expense, ends in 2005 and consequently there is an increase in 2006 depreciation expense equal to the annual true–up adjustment.

As noted above, the 2004 depreciation expense included in the test year was reduced by the amount of the true-up adjustment. Except for this adjustment the revenue requirement for the

2004 test year would have been approximately $5.8 million higher resulting in higher customer rates.

The depreciation rates and forecast depreciation expense for 2004 were reviewed as part of the 2003 GRA. From a regulatory perspective these amounts were determined to be reasonable and prudent and the Company was entitled to recover this cost from ratepayers. Similarly, the accumulated depreciation reserve variance identified in the 2002 Depreciation Study prepared by Gannett Fleming and the proposed amortization of that variance (the true-up adjustment) were reviewed during the 2003 GRA and accepted as being reasonable.

While the Company's proposal may be reasonable in the context of the 2004 test year, the Board must assess the proposal in the context of 2006. The Company provided its forecast for 2006 in Exhibit NP-14 which indicates that with acceptance of all the proposals included in the application, the rate of return on rate base would be 8.56%. This rate of return falls in the lower end of the current range of return of 8.50% - 8.86%. We believe the appropriateness of Newfoundland Power's proposals must be assessed based on whether they provide the opportunity to earn a just and reasonable return in 2006.

However, the Board has not had the opportunity to review all elements of the revenue requirement for 2006. While such a review may confirm that the forecast financial results and rate of return on rate base are reasonable, the Board has been asked to make its determination in the absence of such evidence. If the Board had the benefit of a full review of the revenue requirement it would gain a greater comfort level that the request by the Company is justified and necessary to provide the opportunity to earn a just and reasonable return in 2006.

The increase in depreciation expense which the Company attributes to plant investment amounts to $1.157 million. This component of the increase is a different issue than the true-up adjustment. The Company undertakes a capital program and incurs capital expenditures each year and these expenditures impact a number of elements of the revenue requirement in addition to depreciation. For example, a large portion of plant investment in any given year is attributable to customer growth. Growth in customers leads to increased energy sales and additional revenues to the Company. Other capital projects relate to replacement, refurbishment or upgrading of plant in service which can impact other costs including maintenance expenses. In normal circumstances the ongoing annual investment in plant by the Company does not in itself impact revenue requirement to the extent that the Company would seek rate relief between general rate hearings.

Overall, based on the considerations noted above, we have some concern with addressing the depreciation impact related to plant investment in isolation. The Board may want to consider all related impacts on revenue requirement before accepting the Company's proposal to recognize a portion of the 2005 Unbilled Revenue to offset the $1.157 increase in depreciation attributable to plant investment.

Income tax effects of the Tax Settlement

Under the terms of the Tax Settlement the Company will recognize for tax purposes 1/3 of the 2005 Unbilled Revenue in each of 2006, 2007 and 2008. This will result in additional income taxes of approximately $3 million per year (see Exhibit NP-2). Based on our review of the Tax Settlement and the Company's calculation of the pro-forma income tax effects, we can confirm they are appropriate and reasonable.

In its Application, Newfoundland Power is proposing that it recognize $3,086,000 of the Unbilled Revenue in 2006. This is equal to the pro-forma income tax in that year. The increased income taxes payable by the Company for 2006 is directly related to the recognition of the unbilled revenue for tax purposes and in this regard Newfoundland Power would normally be entitled to recover this cost.

As noted in the Company's pre-filed evidence, recovering the 2006 income tax cost through revenue from rates would attract additional taxes and require additional revenue of $1,745,000 ($3,086,000/(1-.3612))for a total of $4,831,000 of increased revenue. Offsetting the income tax effects with a portion of the Unbilled Revenue on the other hand will not result in additional taxes. Using the 2005 Unbilled Revenue to offset the income tax effects in 2006 is the least cost means of recovering the tax effects from a ratepayer perspective.

We believe the proposal to recognize a portion of the 2005 Unbilled Revenue to offset the 2006 income tax effects of the Tax Settlement is reasonable and appropriate.

Unbilled Revenue Increase Reserve

As noted by the Company, the Board ordered in P.U. 36 (1998-99) that an Unbilled Revenue Increase Reserve be established to account for the impact of the recovery lag which occurs under the Billed Method of revenue recognition when electricity rates change. In this Order the Board directly linked the disposition of this Reserve with any future order dealing with the Company's revenue recognition policy.

The balance in this reserve represents revenue recognized by Newfoundland Power which in theory is due from ratepayers but has not been billed. The Company is proposing that the $295,000 balance in the Unbilled Revenue Increase Reserve be applied against the 2005 Unbilled Revenue which will dispose of the reserve without affecting rates.

Based on our understanding of the circumstances under which this reserve was established, we believe the Company's proposal to apply a portion of the 2005 Unbilled Revenue to eliminate the reserve balance is reasonable and appropriate.

Conclusion

In this section of our report we have provided our comments and findings with regard to Newfoundland Power's various proposals related to the adoption of the Accrual Method and the partial disposition/recognition of the 2005 Unbilled Revenue. Our comments address the reasonableness of each proposal on an individual basis.

Should the Board decide that it does not accept any or all of the Company's proposals then it will need to be aware of the implications of such decisions. In its pre-filed evidence the Company makes references and indicates that without acceptance of its proposals, it would not have the opportunity to earn a just and reasonable return on rate base in 2006. This being the case, it is possible the Company would file a general rate application seeking revised rates for 2006.

As an alternative to denying the Company's proposals the Board may consider allowing the Company to defer some of the costs which are the subject of some of its proposals. Under this approach the shortfall in revenue which Newfoundland Power suggests would occur could be addressed as part of the next GRA which is anticipated for late 2006 to deal with a 2007 test year.

It should be noted that deferring certain costs may give rise to other implications, particularly unfavourable income tax effects, which would also need to be addressed by the Board.

Asset Rate Base Method

In its Application, the Company is requesting the approval of two proposals that will facilitate the adoption of the Asset Rate Base Method ("ARBM"). The first proposal is the approval of the change in accounting policy for revenue recognition to the Accrual Method, and the second is the discontinuation of the use of regulated common equity in the calculation of return on rate base and the use of book common equity in its place.

In P.U. 19 (2003), the Board noted that the ARBM should replace the Invested Capital approach currently used to calculate the Company's rate base. The move to the ARBM began in 2003 by including the deferred charges in rate base. As financial consultants, we noted in our Supplementary Evidence that was filed during the 2003 General Rate Hearing that we had reviewed the two methods and concluded that the ARBM was preferable. However we did note that if the Board were to approve the inclusion of deferred charges in rate base there would still be a number of reconciling items between rate base and invested capital. The Board ordered in P.U. 19 (2003) that the Company "will review no later that its next general rate application, the appropriateness and approach to including the remaining reconciling items in the Rate Base." One of the items to be included in the review was the issue of discontinuing the use of regulated common equity in favor of book equity. In complying with the Board's order, the Company filed a report on the ARBM in its Capital Budget Application and provided an updated report in this Application (Exhibit NP-9).

Working Capital Differences

As the Company explains in Exhibit NP-9, "Asset Rate Base Method Review", the change in accounting policy to the Accrual Method significantly impacts the difference in working capital between rate base and invested capital. Working capital included in invested capital is the difference between current assets and current liabilities as at a particular point in time. Under the current policy for revenue recognition, there has been a large negative working capital balance calculated from the Company's year end balance sheet. This is primarily due to the inconsistencies of recognizing revenue and the expenses incurred to earn the revenue. The year end balance sheet currently does not include the accounts receivable for revenue earned in December but not billed until January of the following year, however the amounts payable to Hydro for purchased power, and all other costs incurred in the delivery of electricity to consumers to the end of the year are accrued and included in the current liabilities. For rate base purposes, a cash working capital allowance is included in rate base and it is calculated using a lead/lag study that examines the timing differences between when revenue is collected and when particular expenses are paid. The Company's method for calculating the allowance to be included in rate base was approved by the Board in P.U. 37 (1984).

As indicated in Exhibit NP-10, the change to the Accrual Method of revenue recognition would result in a substantial reduction in the difference between working capital included in invested capital and the cash working capital allowance calculated for the inclusion in rate base. As noted the reduction is primarily due to the inclusion of unbilled revenue in accounts receivable as of December 31st and because the corresponding regulatory liability (unrecognized 2005 unbilled revenue) is subject to Board determination and therefore not recorded as a current liability. There will always be some differences between working capital included in invested capital verses the inclusion in rate base due to the different methodologies in the calculations, however under the Accrual Method the difference will be substantially reduced.

It is also important to note that, as the Company has indicated in Exhibit NP-9, the new balance sheet requirements introduced by the CICA in AcG-19 will change the Company's balance sheet working capital from a negative balance to a positive balance at December 31, 2005. This will occur because the Company will be required to reflect all current accounts receivable and accounts payable, including all unbilled amounts due from customers in respect of electricity consumed. This also assumes that the corresponding regulatory liability is subject to Board determination and therefore would be recorded as a non-current liability. Table 2 in Exhibit NP-9 provides a comparison of the differences in pro forma working capital before and after the implementation of AcG-19. The difference in working capital will be substantially reduced even if the Company continued the Billed Method of revenue recognition due to the required compliance under generally accepted accounting principles of AcG-19. In prior years, effectively the unbilled revenue and the corresponding regulatory liability were "netted" and not disclosed on the balance sheet.

Regulated Common Equity versus Book Common Equity

The difference between using regulated common equity verses book equity is one of the reconciling that was included in our Supplementary Evidence filed during the 2003 General Rate Hearing. Book common equity is the amount of common equity available to common shareholders disclosed on the Company's financial statements. Regulated common equity is greater than book common equity, as it reflects the cumulative amount of non-regulated expenses net of income taxes in addition to the book equity.

The Company has indicated in its Application that "the inclusion of cumulative non-regulated equity is essentially a legacy issue for Newfoundland Power. As there appears to be no regulatory policy justification for continuing this practice, it would be practical and in the interests of regulatory transparency to discontinue its use."

Mr. John T. Browne's argument for using book common equity verses regulated common equity in the calculation of invested capital is that "NP's book equity represents the amount of equity available to finance its rate base whereas the regulated equity in excess of book equity does not represent a source of funding." We concur with Mr. Browne's argument in support of using book common equity.

It is also worthy to note that Newfoundland and Labrador Hydro ("Hydro") uses book common equity in its calculation of return on rate base and in its written submission during the 2003 General Rate Hearing, Hydro addressed the issue of utilizing regulated common equity in measuring Newfoundland Power's return on equity.

Conclusion

The reduction in the working capital difference, the change to book common equity versus regulated common equity, and the fact that the corporate tax deposit has been eliminated due to the Tax Settlement, means that the difference between rate base and invested capital will be significantly reduced beginning in 2006. The approval of the Company's proposals related to these matters would be a significant step towards the Company moving to the ARBM.

We have reviewed the Company's calculations in NP-9 and NP-10 and can conclude that the methodology is reasonable and no errors were found.

Based on the Board's desire to replace the Invested Capital approach to the ARBM as indicated in P.U. 19 (2003), we concur with the Company's proposals to effectively allow it to move closer to the ARBM.

2006 Forecast Values for Rate Base and Invested Capital

The forecast values for average rate base and average invested capital for 2006 for use in the Automatic Adjustment Formula are included in Exhibit NP-11 and Exhibit NP-12 respectively.

The forecast average rate base is $744,326,000 which incorporates the Company's proposals set out in its Application. The most significant change affecting rate base is the inclusion of the average balance of the unrecognized 2005 Unbilled Revenue as a reduction of the rate base. The appropriateness of this change was addressed previously in our report.

The forecast average invested capital for 2006 is $745,752,000 which incorporates the Company's proposals set out in its Application. The most significant change affecting invested capital is the use of book common equity instead of regulated common equity. This change was also addressed in the previous section of this report.

Our procedures with respect to verifying the calculation of average rate base and average invested capital were directed towards the assessment of the reasonableness of the data incorporated in the calculations and the methodology used by the Company. Specifically, the procedures which we performed included the following:

- agreed all carry-forward data to supporting documentation including prior years audited financial statements and internal accounting records, where applicable;
- agreed forecast data (capital expenditures; depreciation; etc.) to supporting documentation to ensure it is internally consistent with pre-filed evidence and other areas of the forecast;
- checked the clerical accuracy of the continuity of the rate base and invested capital as forecast for 2006;
- recalculated the forecast average rate base and forecast average invested capital for 2005 to 2006;
- agreed the approach and methodology used in the calculation of the average rate base and average invested capital to ensure it is in accordance with established policy and

procedure and incorporates the proposals put forward by the Company in this Application.

With regard to the Company's proposed changes impacting rate base and invested capital, it should be noted that should any of these proposals not be accepted by the Board, then Newfoundland Power may have to revise and resubmit forecast 2006 values for use in the Automatic Adjustment Formula.

The average deferred charges included in the forecast rate base were previously reviewed by us as part of the Capital Budget Application. The balances of the various component items have been revised and updated in this Application and we have reviewed the revised numbers and obtained support and explanations for the changes where appropriate.

Based upon the results of the above procedures we did not note any discrepancies in the calculation of the forecast average rate base and forecast average invested capital, and therefore conclude that the forecast average rate base and forecast average invested capital included in the Company's Application are reasonable.